FRBSF Weekly Letter

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Recent Bank Failures

The number of bank failures in the U.S. has increased steadily over the past several years. It reached 120 in 1985 — far more than in any other year since the Great Depression. In addition, the Federal Deposit Insurance Corporation continues to rate more than 1100 banks as "problem" banks based on its assessment of their capital, assets, management, earnings, and liquidity (CAMEL rating). These figures seem to indicate that the rise in bank failures that began in 1982 has not yet run its course. This *Letter* examines recent trends in bank failures, their causes, and ways in which failures are resolved by bank regulators.

Recent experiences

Until 1981, bank failures in the post-World War II era averaged about six per year and, except for the occasional failure of a very large bank (e.g., Franklin National in 1974), were not a source of great concern to most observers. Since 1982, however, the number of bank failures has grown rapidly, rising from 10 in 1981 to the post-Depression record level of 120 in 1985 (see chart).

The assets of banks that failed in 1985 amounted to $9.1 billion, or nearly three times the $3.3 billion 1984 level (a figure that excludes the Continental Illinois rescue). More than half of the 1985 total was due to the failure of a single New York savings bank (Bowery Savings Bank, assets of $5.3 billion). Except for the assets of this organization and one other sizable savings bank (also in New York), the total volume of assets in failed banks in 1985 was nearly identical to that in 1984. In all, the assets of failed banks in 1985 represented less than one-half of one percent of total U.S. bank assets.

Banks that failed in 1985 generally were smaller than those that failed in 1984. The smaller average size of failed banks in 1985 mainly reflected the greater concentration of bank failures within farmbelt states, where banks tend to be relatively small. For the year, the average size failed bank held $28 million in assets (ignoring the two large savings bank failures), as compared to $41 million in assets in 1984. The largest commercial bank to fail in 1985 held assets of $214 million, while the smallest held assets of $2.7 million. All but six of the 120 banks that failed in 1985 had assets of less than $100 million.

Economic factors in recent failures

Empirical research offers somewhat limited insight into the broader causes of bank failures by linking them to such economic variables as the unemployment rate, real interest rates, and the level of corporate debt burden. An analysis of recent failures, however, suggests that more specific economic factors have played an important role.

Certainly, with sharp recessions in 1980 and 1982, commercial bank loan quality has suffered. For a number of banks, the problems have persisted well into the recovery because asset quality has been slow to improve in many lending areas. Specifically, an overall improvement has been hampered by a shift from a high-inflation to a low-inflation environment, a relatively strong dollar, persistently high real interest rates, reduced export demand for commodities, and declining farmland and energy prices. Thus, many banks remain saddled with poor quality agricultural, energy, and real estate loans.

Geographic distribution

The geographic distribution of failed banks supports this view. From 1982 through 1985, there were 289 bank failures in the U.S. Seventy percent (201) of these failures occurred in ten states whose economic fortunes are closely linked to the farming and energy industries. These states include Kansas, Iowa, Nebraska, Illinois, Missouri, Oregon, Oklahoma, and Texas. Two other states — California and Tennessee — also experienced numerous bank failures during this period. Failures in Tennessee during the 1982-85 period (31) were largely the result of a major fraud and insider abuse scandal involving numerous commonly owned banks. Bank failures in California (20) were the result of a diversity of factors including agricultural and real estate lending problems. Foreign loans do not appear to have contributed significantly to bank failures in any state during the 1982-85 period. Furthermore, it is important to note that twenty-seven states experienced only one or no bank failures during the 1982-85 period.

The problems of farm banks — those with more than 25 percent of their loans in agricultural credits — have become most acute in recent years. In 1985, farm bank failures accounted for slightly more than half (62 of 120) of all bank failures. This compares to one-third in 1984 and less than one-fourth in 1983 and 1982. Nebraska (13), Iowa (10), and Kansas (9) led the way in farm bank failures in 1985. Eight other states also recorded a total of thirty farm bank failures in 1985. Depressed farm land prices and commodity prices are expected to persist in 1986 and will likely cause additional farm bank failures.

A substantial number (16) of non-farm bank failures also occurred in Texas and Oklahoma last year. Many of these failures, as well as several failures in Wyoming, can be attributed to energy-related loans exposure. The recent plunge in oil prices will only exacerbate such problems.

A scattering of bank failures occurred among other states during 1985. California recorded seven bank failures, while New York had four and Florida two. The cause of insolvencies in these states is more difficult to pinpoint. The presence of important real estate markets within these states suggests that problems in this lending area may have been responsible for some failures.

Effects of deregulation

In addition to farm, energy, and real estate lending problems, some economists believe that financial deregulation and innovation are contributing to bank failures in the 1980s. Deregulation of deposit interest rates has been accompanied by increased competition from new sources — banking and nonbanking alike. This heightened level of competition has meant that banks now operate in a harsher and less forgiving environment in which poor management, fraud, and insider abuse (a contributing factor in as many as three-fifths of all failures since 1980) exact greater penalties than before.

Deposit deregulation and expanded lending and investment powers have been argued to contribute to instability in banking by fostering increased risk-taking by banks. Many argue that the assumption of additional risk is encouraged by what is generally perceived to be a deposit insurance subsidy that partially insulates banks from the costs of assuming higher levels of risk. Deregulation, they argue, gives banks greater scope to act on the incentives to take risks. Some economists, however, take exception to the view that deregulation is at the core of the current spate of bank failures. They contend that the failures are due simply to deteriorated conditions in the agriculture and energy sectors.

Handling failed banks

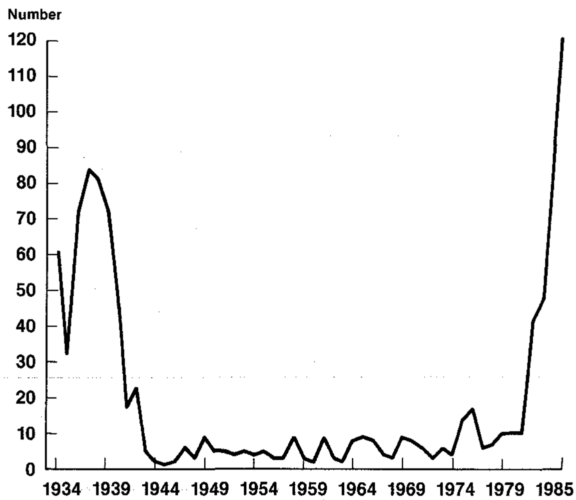
When a bank fails, the FDIC — a government-run corporation that insures depositors up to $100,000 against loss — can exercise several options in its role of protecting depositors. Its settlement practices are what some observers believe have encouraged banks — especially large banks — to incur excessive risks in recent years.

When a bank fails, the FDIC usually employs either a deposit payoff or a purchase and assumption ("P&A"). In a deposit payoff, the FDIC pays depositors the value of their accounts (up to $100,000), and sells the failed bank's assets to pay off creditors, including the insurance fund and uninsured depositors. Creditors suffer a loss if the proceeds of the asset sale do not cover creditor claims.

In a P&A, the failed bank is sold to another financial institution that is willing to assume most of the bank's liabilities (including all deposits). In return, the acquiring institution receives the failed bank's good assets (performing loans, securities, physical plant) plus cash from the FDIC for the amount by which the assumed liabilities exceed the purchased assets minus the premium paid by the acquiring bank.

Because of the manner in which the FDIC has handled P&As for bank failures, few uninsured depositors at large institutions have suffered losses. Critics of the FDIC argue that the FDIC's settlement practices and the government's

FDIC-Insured Bank Failures



pledge never to permit a large bank to fail have created *de facto* deposit insurance for all deposits at large banks, including those that are legally uninsured.

They argue that in the past this has bestowed a deposit-gathering advantage on the largest banks and reduced the crucial role of "market discipline" in restraining risk-taking. Because past guarantees made smaller failed banks more likely to be liquidated at a loss to the uninsured depositor, they may have encouraged large depositors to place funds only in the largest banks.

Without deposit insurance, market discipline would dictate that riskier banks pay more for their funds to compensate depositors for taking greater risks. With *de facto* insurance for all deposits, poorly managed banks or those with low quality assets can raise funds almost as cheaply as much stronger institutions because depositors have little to fear about losing their funds and therefore will not demand as high a risk premium.

Supporters of current settlement practices point to the dangers of moving toward greater market discipline. The present system of formal and informal guarantees, they argue, has worked well to create a sound and stable banking system. Any shift to increased market discipline could create destabilizing effects by forcing the private sector to speculate on the health of individual banks. The continual prospect of runs precipitated by rumors of troubled banks could jeopardize the entire banking system. In response, many banks would probably become much more conservative in their lending policies and restrict the availability of credit to all but the most creditworthy customers.

Proponents of this view argue in favor of continued reliance on the P&A or, alternatively, a government takeover of large failed banks — an option that, in effect, was exercised in the 1984 Continental Illinois episode. Such takeovers result in losses to shareholders but protect depositors and allow the troubled bank to remain in operation under the regulators' control. Takeovers also give formal recognition to the fact that federal guarantees become the largest asset of the failed bank and that federal guarantors comprise the bank's largest claim holder.

Summary

Last year was a record year for bank failures, with many of them involving relatively small institutions concentrated in a small number of farmbelt and energy-producing states. Banks in those states have been adversely affected by a number of factors including two recessions, persistently high real interest rates, a strong dollar, and declining prices for commodities, farm land, and energy.

A similarly large number of bank failures is expected during 1986 with the failures again to be heavily concentrated within the farmbelt region. Increased failures also could occur among energy banks — particularly in view of the recent and sizable drop in oil prices. However, because the failures will result from specific economic developments whose impacts vary by region and bank portfolio, they do not signal any fundamental weakness in the banking system.

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Editorial comments may be addressed to the editor (Gregory Tong) or to the author . . . . Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/19/86	Change from 3/12/86	Change from 3/20/85 Dollar	
Loans, Leases and Investments[1] [2]	202,180	531	12,618	6.6
Loans and Leases[1] [6]	183,622	872	11,649	6.7
Commercial and Industrial	53,110	305	– 66	– 0.1
Real estate	66,469	198	3,915	6.2
Loans to Individuals	38,981	565	5,957	18.0
Leases	5,648	2	327	6.1
U.S. Treasury and Agency Securities	10,577	– 263	– 69	– 0.6
Other Securities[2]	7,980	– 79	1,036	14.9
Total Deposits	200,099	– 615	6,798	3.5
Demand Deposits	47,553	– 142	3,593	8.1
Demand Deposits Adjusted[3]	32,317	– 222	3,885	13.6
Other Transaction Balances[4]	15,326	– 57	2,111	15.9
Total Non-Transaction Balances[6]	137,220	– 417	1,095	0.8
Money Market Deposit Accounts—Total	45,950	– 9	2,089	4.7
Time Deposits in Amounts of $100,000 or more	37,545	– 278	– 1,413	– 3.6
Other Liabilities for Borrowed Money[5]	25,915	287	8,363	47.6

Two Week Averages of Daily Figures	Period ended 3/10/86	Period ended 2/24/86
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	22	71
Borrowings	30	191
Net free reserves (+)/Net borrowed(–)	– 8	– 119

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change